Chart in focus

Non-performing loans: Peripheral countries finally on the road to recovery

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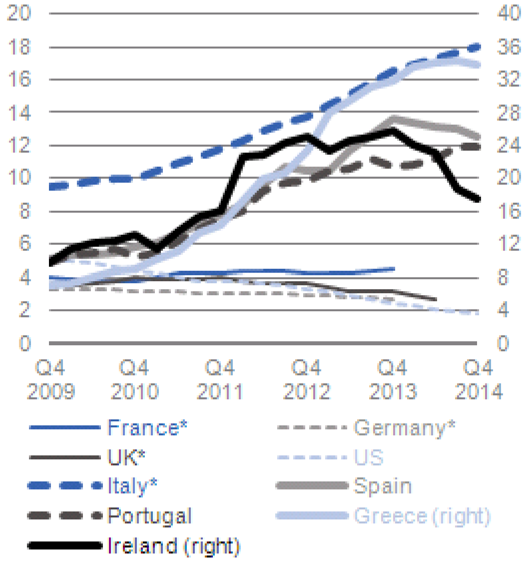
After suffering from two deep economic downturns following the financial crisis and the sovereign debt crisis, the economies of the peripheral countries in Europe eventually stabilised in 2014 or even started growing again. The general outlook for this year is better still. Against this background, also the prospects for the banking system are improving, not least thanks to a recovery in loan books. For several years NPL ratios (the ratio of non-performing loans to total gross loans) were increasing in the periphery and thus diverging from the much lower ratios in more “solid” countries such as France, Germany and the UK (or, for that matter, the US). Last year, however, NPL ratios in most of the troubled countries finally started to level off and even decline. Interestingly, the changes either way were almost always driven by movements in non-performing loans rather than in total loans outstanding (a heavy decline in the lending volume in Ireland in 2009-12 being the exception). Furthermore, coverage ratios – i.e. the volume of loan loss provisions relative to non-performing loans – remained broadly stable, implying that banks were neither particularly aggressive nor reluctant to set aside funds to cover future loan write-offs.

NLPs: Peripheral countries finally on the road to recovery

Non-performing loans as % of total loans



* No data available for Q1 and Q3, data for Germany only available for Q4.

Sources: IMF, Banco de España, Banco de Portugal, Deutsche Bank Research

Banks from the “solid” countries had fairly low NPL ratios at the beginning of the Great Recession, and the figures kept declining to below 3% for all these countries, except for France, where the share of loans overdue stayed largely constant at about 4%. This picture is mirrored by GDP growth rates, which since 2010 were consistently positive for these countries but lowest in France.

In contrast to the more robust countries, many banks in the peripheral economies already suffered from a significantly higher level of NPLs at the onset of the recession in 2009. From this weaker starting point, and despite the establishment in some countries of bad banks which took troubled loans off banks’ balance sheets, NPL ratios increased steadily until the end of 2013. The rise accelerated at the peak of the sovereign debt crisis in the summer of 2012, when the crisis-hit countries relapsed into a second economic downturn. With the support from the ECB and their own economic adjustments paying off, the economic outlook for the peripheral countries – as well as asset quality – then gradually improved:

- Ireland experienced a drop in its NPL ratio from roughly 26% in Q4 2013 to 17.5% at end-2014. This coincided with a boom in the economy and an increase in house prices of 16% in 2014.
- Likewise, Spain turned the corner in 2014. With the economy returning to growth and the housing sector stabilising, banks’ asset quality also improved; in fact it has now done so for six consecutive quarters already.
- NPL ratios in Greece decreased for the first time quarter-over-quarter in Q4 2014 after the economy had started growing again following a six-year-long, heavy recession. Nevertheless, the NPL ratio remained at the precarious level of 34%.

Prospects for further improvement are especially promising in Spain, Ireland and Portugal: Deutsche Bank Research forecasts GDP growth of 3%, 3.7% and 1.6% respectively in 2015. Italy’s economy, too, is predicted to expand again, which may help Italian banks whose NPL ratios were still deteriorating until the end of 2014. In addition to the positive macro environment, credit quality in future may also benefit from a second factor: tighter lending standards. Indeed, the bank lending survey shows that European banks have raised their lending standards strongly in recent years – especially during the financial crisis and at the peak of the sovereign debt crisis. This should contribute to a meaningful reduction in loan defaults going forward. Against this background, it looks likely that NPL ratios in most peripheral countries will continue to decline. Risks, however, are evident for Greece: given the mounting economic uncertainty as well as the deterioration in business confidence over recent months and the current aggravation, it seems almost certain that the positive NPL trend of the second half of 2014 has already gone into reverse.

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